Money and Risk Management

Preview

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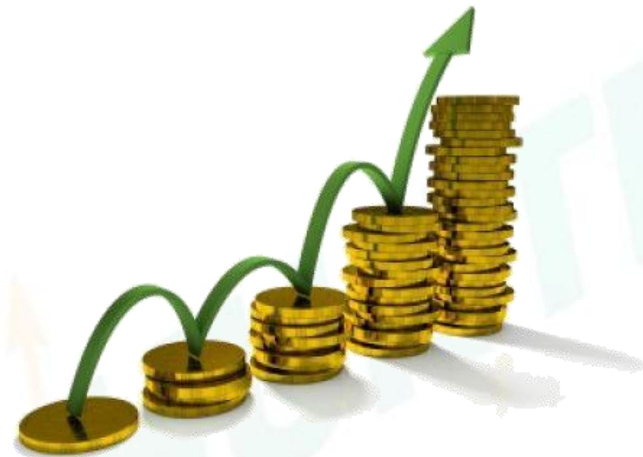
Money and Risk Management



- Antimartingale systems
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Money Management

The most important parts of Money Management trading is looking for the answer to the “how many contracts” and “how much money” questions.

How many shares can I buy in a certain moment?

How much money can I risk on a certain position?

Money Management determines both our profits and losses.

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Creative Money Management

Determining the initial conditions

Assume we have $100,000 on our account. A **3x stop** is applied following the **volatility-based model**. The **combined risk** of all open positions **cannot exceed 24%**. The **Reduced Total Equity Method** is used on the model. According to the plans, if we can open **maximum 6 positions in the same time**, but we are willing to **risk more than 4% on one position**. **The initial risk is 2%.**

The trade

Let's buy wheat for $3.025. The 10-day ATR (shown as *V* from now on) is 3.5 cent. The 3x value is 10.5 cent, so the stop level is $2.92. This means $525 risk (1 contract is 5,000 bushels of wheat). The initial risk is 2% of the total equity. Thus, 3 contracts of wheat can be bought.

According to he **pyramid system**, 1 contract can be bought every time when the profit increases with *V* (3.5 cent). When this happens - when the wheat price reached $3.05 - we should buy and take on a 2% initial risk again and apply *V* stop which is now $2.955. Now we have 6 contracts of wheat and another at a $2.999 stop. The total risk on our equity is now 3%.

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If *V*-s value increases to 4 cent. The new stop is 12 cents, so $600. The price of wheat increases to $3.10, so we risk another 2%. The basis will be $97,000 according to the *Reduced Total Equity Method.* The 2% of that is $1,940. So we buy again 3 contracts of wheat for $3.10, using a 2.98 stop. **Then, the stop should be increased for the open wheat contracts as well.** There are 6 wheat contracts in our portfolio with $2.99 stop price and another 3 contracts with $2.98 price. The table illustrates that the risk on all positions is $3,375, which is the 3.375% of the total equity.

Contract	Current stop	Initial risk	Total risk to Original Equity
3 contracts for $3.025	$2.99	3.5 cent	10.5 cent = $525
3 contracts for $3.06	$2.99	7 cent	21 cent = $1.050
3 contracts for $3.10	$2.98	12 cent	36 cent = $1.800

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Assume that the volatility stays at 4 cent and currently wheat costs $3.14. It's time to risk another 2%. The basis will be $96,525 according to the *Reduced Total Equity Method.* The 2% of that is $1,932.50. With a 12 cent stop, we can purchase again 3 contracts. At this time the stop of the open positions must be raised. The first 6 contracts' stop will be at $3.025 ($2.99 the initial stop + 3.5 cent). The other 3 wheat contracts' stop rose to $3.02.

Contract	Current stop	Initial risk	Total risk to Original Equity
3 contracts for $3.025	$3.025	0 cent	0 cent = $0
3 contracts for $3.06	$3.03	3.5 cent	10.5 cent = $550
3 contracts for $3.10	$3.02	8 cent	24 cent = $1.200
3 contracts for $3.14	$3.02	12 cent	36 cent = $1,800

The risk is now $3,550 or 3.55%, which is still below 4%.

Assume that *V*'s value increases to 6 cent. There is another chance to purchase. The price of wheat is now $3.20.

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The basis is $96,450 according to the *Reduced Total Equity Method.* The 2% of that is $1,929. The 3x *V* stop is now 18 cents, so $900. Now we can only buy 2 contracts of wheat and the stop of the open positions must be raised again. Now a decision is made with which we do not change the margin point, so the position will have more place to move. However, the second 3 contracts' stop will be adjusted to the margin. The wheat bought at $3.10 will have the stop at $3.06. The wheat's stop that was bought at $3.14 will be modified to the same level.

The table below shows the positions:

Contract	Current stop	Initial risk	Total risk to Original Equity
3 contracts for $3.025	$3.025	0 cent	0 cent = $0
3 contracts for $3.06	$3.06	0 cent	0 cent = $0
3 contracts for $3.10	$3.06	4 cent	12 cent = $600
3 contracts for $3.14	$3.06	8 cent	24 cent = $1,200
2 contracts for $3.20	$3.02	18 cent	36 cent = $1.800

The risk is now $3,600 or 3.6%, which is still below 4%.

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The wheat price increases to $3.26 while *V* stays at 6 cent. Consequently a new position is opened with 2% initial risk and the stop of the open contracts are increased by the amount of *V*. We can buy again 2 contracts with a $3.08 stop.

The portfolio is the following:

Contract	Current stop	Initial risk	Total risk to Original Equity
3 contracts for $3.025	$3.025	0 cent	0 cent = $0
3 contracts for $3.06	$3.06	0 cent	0 cent = $0
3 contracts for $3.10	$3.10	0 cent	0 cent = $0
3 contracts for $3.14	$3.10	4 cent	12 cent = $600
2 contracts for $3.20	$3.08	12 cent	24 cent = $1.200
2 contracts for $3.26	$3.08	18 cent	36 cent = $1.800

The risk is now $3,600 or 3.6%, which is still below 4%.

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With further increase in wheat price we can open new positions with the previously illustrated technique. Do not increase the stop above the margin points. With new positions it is unlikely that the 4% risk will be exceeded, but there should be a limit on purchasing.

Assume that the price of wheat has fallen and we receive a short signal. The short signal is independent from the Money Management stops. The sale happens at $3.21. We earn 55.5 cent on the first three contracts, 45 cent on the second 3, 33 cent on the third 3, 21 cent on the fourth 3, and 2 cent on the fifth 2, while 10 cent was lost on the sixth trade. The total profit is $7,375.

$1,575 was risked on the first 3 contracts. If the 4% maximal risk is exploited initially, then 7 contracts would have been bought with $3,675 risk and would have earned $6,475 at the end.

Naturally, a rally against us or a bigger gap are risks so it is recommended to protect the positions with options.

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Advantages/disadvantages of Money Management models

Money Management models	Advantages	Disadvantages
Units per Fixed Amount of Money trading	•No trades are rejected •Can be used with small capital •Minimalised risk on individual trades	•Handles trades with different amount of money as well •Equity can increase only slowly
Equal Units trading	•Each investment has the same weight in the portfolio	•The size can be only slowly increased for traders with small equity •The frequency of investment is not equal
Percent Risk trading	•Can be applied on both small and large accounts •The performance of the portfolio is balanced by the actual risk	•Some trades must be rejected due to their riskiness •The risked amount is not the actual risk
Percent Volatility trading	•Can be applied on both small and large accounts •The performance of the portfolio is balanced by the volatility	•Some trades must be rejected due to their riskiness •The daily volatility is not the actual volatility

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Risk Management

While Money Management answers how much money one can invest in the next trade to maximize profits, **Risk Management controls the maximum loss or minimalizes the loss**.

Risk and Money Management systems find the balance between the maximum profit and the minimum risk.

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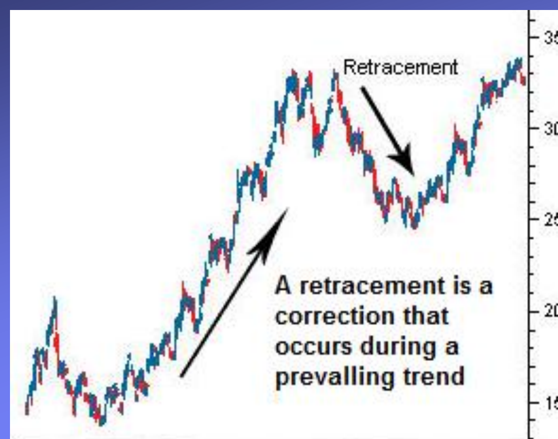
Profit retracement stop

What is Retracement?



Consolidation or pull-back phases in the primary trend are called retracements. The price usually tests back before moving in the primary trend's direction again.

Fibonacci Retracement is the most common way to determine Retracement price levels.

It is constructed by connecting two extreme points and defines the following levels: 0.0%, 23.6%, 38.2%, 50%, 61.8%, and 100%.

In this kind of stop order the trader gives up some of the profit to earn more. To make the strategy work, a certain profit level must be reached.

Assume that we buy Micron stock at $52. The initial risk is $6, so we will close the position at $46. This is called the *1-R* risk level. To reach the *2-R* level, the price must increase by $12 (reach $64). If the price reached this level, then we can start realising the profit. Determine a *profit retracement level* at 30%. We will give up $3.60 - 30% of the $12 profit.

If the profit is $13, the 30% of it is $3.90. If it is $14, the 30% will be $4.20. If the price keeps increasing we might decide to decrease the *retracement* level. From the initial 30% on the *3-R* level only 25%, on the *4-R* level only 20% to give back to the market. The steps and levels must be adjusted to our system.

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Parabolic stop

The Parabolic stop became commonly used thanks to *Wilder*. The parabola's starting point is a *previous trough* which changes with an *accelerating factor* as the market moves upwards. **As the market is trending, the stop price gets closer and closer the to the price.** Its disadvantage is that the stop is far from the price initially which can generate large losses. It is also true the opposite way: it can be so close that after the activation of the stop the market continues the rally and the larger profit won't be captured. The accelerating factor can be adjusted which will optimise the profit levels.

For instance, if the parabolic stop is $3,000 initially, then we may decide to determine the initial risk at $1,500 until the parabolic stop does not reach that level.

One can think about re-entering techniques since the parabolic stop can knock out instruments on trending markets also.

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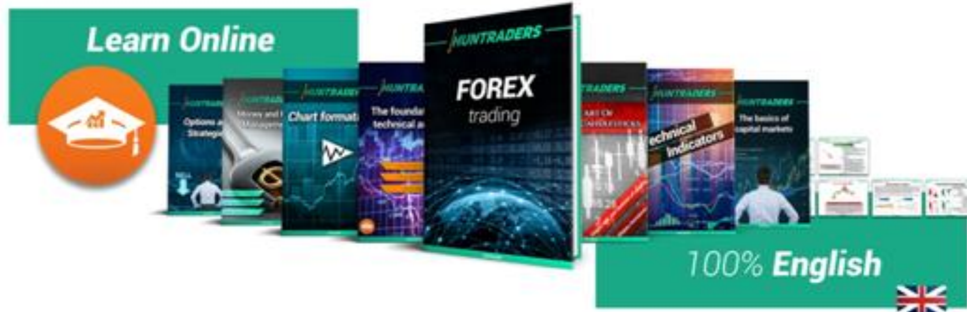

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